Make the complex simple

PETER WILLIAMS REPORTS FROM AN ACT CONFERENCE ON HOW THE NEW INTERNATIONAL FINANCIAL REPORTING STANDARDS ARE BEDDING IN AND INTEGRATING WITH PRACTICAL RISK MANAGEMENT.

At the recent ACT conference, IFRS and Shareholder Value: An Unlikely Marriage, sponsored by Lloyds TSB Corporate Markets, it was clear that treasurers remain sceptical over international financial reporting standards (IFRS).

Conference Chairman Helen Jones, Global Head of Tax and Treasury at Reuters, asked attendees whether, after two years to familiarise themselves with IFRS, they thought investors understood their accounts better under IFRS than under UK GAAP. The response was emphatic: 24% said yes, but 76% said they understood less.

Of the 24% who thought IFRS had improved investor understanding, 57% said it was because IFRS had improved the quality of reporting the financial performance of their company. Other reasons included corporates disclosing adjusted profits and commenting on the figures in the Operating & Financial Review (OFR). And nearly 30% thought investors had become smarter!

The conference was split over whether IAS 39 *Financial Instruments: Recognition and Measurement* had contributed to an increased focus on and better understanding of treasury activities by senior management, with 46% saying it had, and 54% disagreeing.

Whatever treasurers' views, IFRS is here to stay. Bernd Hacker, Head of Standard Setter Liaison and Financial Instruments Accounting Policies at Siemens, looked at the prospects for global convergence of accounting standards.

The key question, he said, was the approach of the US and the EU. In June the US Securities and Exchange Commission (SEC) proposed eliminating the requirement for a foreign company that prepares its financial statements using IFRS to reconcile to US generally accepted accounting principles (GAAP). The auditor would give an opinion on the conformity of the accounts. The SEC is also contemplating allowing US domestic issuers to report under IFRS rather than GAAP.

However, the SEC's proposal only applies to IFRS as adopted by IASB. IFRS has been adopted with variations in particular jurisdictions, notably the EU, which has a carve-out for financial instruments. The EU claims the way the SEC envisages accepting IFRS undermines the role of European legislators and supervisors, such as the Committee of European Securities Regulators (CESR), in international accounting standards. The EU wants mutual recognition with the US of accounting standards without reconciliation. The IASB is known to be concerned by the threat of regionalisation of its standards and is unlikely to be sympathetic to the European position.

One of the key problems in international accounting remains hedge accounting. Johann Kruger, of Lloyds TSB Corporate Markets, spoke to the conference about how to get more out of hedge accounting. He said hedge accounting had moved from an income statement focus to a balance sheet focus with complex rules reflecting the complexity of the subject. IAS 32 and IAS 39 set out very particular treatment for financial instruments with a fair value approach that had few exceptions. To obtain hedge accounting, treasurers have to ask whether a genuine economically valid hedge exists. If it does, corporates can apply hedge accounting as far as possible although certain elements are open to interpretation.

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Under the principles-based approach, auditors are encouraged to apply judgement but, according to Kruger, have "enough ammunition to prevent manipulation of the accounts". Kruger asked the conference how responsive auditors were to financial instrument IFRS issues. On a scale of one to five (one being poor, five good), the auditors were rated on average at 2.65 by the treasurers present. When asked whether they saw IAS 39 support from banks as a key element of any risk management analysis, conference attendees were more positive, with the average working out at 3.16.

Kruger also asked the conference what level of volatility in their income statement would they be prepared to tolerate caused by IAS 21 and IAS 39 if there was a conflict between economically optimal hedging and capital structure and income statement volatility. Nearly a third (31%) would tolerate 1% of profit before tax, 33% up to 5% and a quarter would allow 10%. But it seems that whatever the company's tolerance this is not yet approved at board level. While 13% said the treasury policy authorised by the company's board reflected the answer of income volatility, 77% said the formal hedging policy did not mention the issue.

On the day-to-day business of hedging, Kruger urged treasurers to ask their bank for help. He said treasurers should support the IASB in its quest for reporting economic substance and at the same time should educate their shareholder base to understand the company's hedging programme.

One finance professional already communicating on the issue to shareholders is Martin Wheatcroft, Chief Accountant for National Grid. The company was an early adopter of IFRS 7 *Financial Instruments*, which requires balance sheet analysis of financial instruments in terms of maturity, currency and fair values, as well as risk disclosures in terms of market, credit, liquidity and sensitivity analysis and derivative and hedging analysis by hedge type. Wheatcroft said IFRS 7 was a better fit than IAS 32 for the company, which was well placed for early adoption because the 20-F risk disclosures were already in existence. He showed the conference how the company had changed the style of disclosure using interest rate risk as an example in a bid to make the complex simple.

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